UNDERSTANDING MODERN CAMELS, PART 6: SENSITIVITY

Sixth in a series about what regulators want in a CAMELS

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Jeff Gerrish has been taking readers through a six-part look at the modern essentials of the CAMELS system. Read his takes on Capital, Assets, Management, Earnings, and Liquidity after you read this final installment on Sensitivity to market risk.

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Are you or your bank the "strong, sensitive type"?

Then you should be in good shape with the regulatory rating of "Sensitivity" in connection with your CAMELS rating.

Sorry, couldn't resist the joke.

As the last in the series of the CAMELS rating blogs, Capital, Assets, Management, Earnings, Liquidity and now, Sensitivity, this blog will confirm that the strong "sensitive" bank will do well.

Unfortunately, this does not mean that if your CEO is the type that weeps at phone company commercials that your bank

will be higher rated on Sensitivity. Nor does it mean that if your bank personnel make hospital visits on a regular basis, the bank will do well on its Sensitivity rating.

The examiners are looking for something different.

Significance of market risk

The Sensitivity rating represents examiners' attempt to rate a bank's "sensitivity to market risk." For all community banks, that means sensitivity to interest rate risk. For agricultural community banks, it may also mean sensitivity to commodity prices, farm prices, or other changes in the future that could adversely affect the institution's earnings or economic capital.

The Sensitivity rating as a portion of the CAMELS rating, as a practical matter, is one of the building blocks in the regulators' push toward "forward-looking" supervision, which I've blogged about before.

The Sensitivity component will look at sensitivity to market risk today, but by default, is required to consider sensitivity to market risk in the future, as well.

That is basically forward-looking supervision where the regulators take a snapshot today, but also attempt to predict the future. (How is that for ultra-subjective?)

How examiners assess sensitivity

As with the other component ratings in the CAMELS rating system, the regulators generally consider sensitivity to market risk from a perspective of management's ability to identify, measure, monitor, and control market risk. (In this context, "management" includes the board.) There should be some consideration when looking at sensitivity to market risk with respect to the institution's size, complexity, capital, and earnings adequacy in relation to its market risk exposure.

Unlike asset quality, which drives a number of the other components, Sensitivity is somewhat more isolated.

As with the Liquidity component discussed in the previous blog, if a bank is overall rated a CAMELS 1 or a 2, then sensitivity to market risk will probably be rated a 1 or a 2 as well. If the bank's overall CAMELS rating is a 4 or a 5, then almost by default, the onsite examiners will not provide a Sensitivity rating higher than a 3.

Now, let's be more specific. In connection with the examiners' consideration of "sensitivity to market risk," there are a number of factors that are evaluated, including:

- • The sensitivity of the bank's earnings or capital to changes in interest rates, commodity prices, or equity prices.

- • The ability of management to identify, measure, monitor, and control the exposure to market risk.

- • The nature and complexity of interest rate risk exposure.

Scoring for sensitivity

Sensitivity to market risk is a component of the CAMELS ratings. As with the other ratings, it is rated from a 1 to a 5. The 1 rating (the highest) indicates that "market risk sensitivity is well controlled and that there is a minimal potential that the earnings performance or capital position will be adversely affected."

On the other hand, a Sensitivity rating of 5 indicates that "control of market risk sensitivity is unacceptable or that the level of market risk taken by the institution is an imminent threat to its viability."

A 2 rating on sensitivity to market risk means that the market risk sensitivity is "adequately controlled." A 3 indicates that it "needs improvement." A 4 indicates that it is "unacceptable" or there is high potential that earnings or capital will be adversely impacted.

The bottom line of all this is in this environment, if you are a community bank, stay strong and "sensitive," particularly to interest rate risk.

About the Author

Jeff Gerrish is chairman of the board of Gerrish McCreary Smith Consultants, LLC, and a member of the Memphis-based law firm of Gerrish McCreary Smith, PC, Attorneys. He is a frequent contributor to ABA Banking Journal and ABA Bank Directors Briefing, and frequently speaks at ABA events and telephone briefings.

Gerrish formerly served as Regional Counsel for the Memphis Regional Office of the FDIC, with responsibility for all legal matters, including cease-and-desist and other enforcement actions. Before coming to Memphis, Gerrish was with the FDIC Liquidation Division in Washington, D.C. where he had nationwide responsibility for litigation against directors of failed banks.

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